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Sec Proposes New Restrictions On Investment Adviser Pay To Play Activities

On August 3, 2009, the Securities and Exchange Commission ("SEC") issued Release No. IA-2910 under the Investment Advisers Act of 1940 (the "Advisers Act") to propose a new Rule 206(4)-5 (the "proposed rule") which would ban certain "pay to play" practices of investment advisers who make political contributions to elected officials or candidates in order to obtain business from the pension funds controlled by those officials or candidates. Release No. IA-2910 is available at http://www.sec.gov/rules/proposed/2009/ia-2910.pdf.

The proposed rule represents a return to this issue by the SEC, which first proposed and failed to adopt a similar rule in 1999. The proposed rule is modeled on rules G-37 and G-38 of the Municipal Securities Rulemaking Board, which addresses pay to play practices in the municipal securities markets and which the SEC notes has been effective in limiting pay to play abuses in the municipal securities marketplace. The proposed rule comes in the wake of a number of legal proceedings and investigations initiated by the SEC and by state authorities, including an SEC civil action charging former New York State officials, as well as a "placement agent," with engaging in a fraudulent scheme to extract kickbacks from investment advisers seeking to manage assets of the New York State Common Retirement Fund. A number of states, including California, Connecticut, Hawaii, Kentucky, Maryland, New Jersey, New Mexico, Ohio, Pennsylvania, South Carolina, Rhode Island and West Virgin ia, as well as a number of municipalities, have adopted pay to play laws.

Applicability

The proposed rule would apply to any investment adviser required to be registered with the SEC and to those who are exempt from registration with the SEC based on the exemption from registration for investment advisers who neither hold themselves out to the public as investment advisers nor advise a registered investment company and who have had fewer than 15 clients during the course of the past 12 months.

The proposed rule would also be applicable to advisers to "covered investment pools" in which a government entity invests or is solicited to invest. Such advisers would be treated as though that adviser were providing or seeking to provide investment advisory services directly to the government entity. The proposed rule defines a "covered investment pool" as (i) any investment company as

defined in section 3(a) of the Investment Company Act of 1940 ("Investment Company Act"); or (ii) any company that would be an investment company under section 3(a) of the Investment Company Act but for the exclusion provided from that definition by section 3(c)(1), section 3(c)(7) or section 3(c)(11) of that Act. Thus, the proposed rule would apply to managers of hedge funds, private equity funds, and other "private" funds. Investment managers of "covered investment pools," including mutual funds and collective investment trusts, would also b e covered if the mutual fund or collective investment trust is selected as an investment option under a retirement plan, such as a 403(b) plan or 457 plan, or under a 529 plan for college savings.

The proposed rule would be inapplicable to state-registered investment advisers although the SEC is seeking comment on whether that should be the case.

Key Provisions

Rule 206(4)-5 would control abusive pay to play practices through three measures:

- ***The Two-Year Rule.*** It would be unlawful for an adviser to receive compensation (but not unlawful to provide investment advisory services) for providing advisory services to a government entity for a two-year period after the adviser or any of its covered associates makes a political contribution to a public official of the government entity that is in a position to influence the award of advisory business. The types of governmental entities to which this would apply would include state pension funds, state-directed 529 college savings plans, or any state or local government-controlled fund. There is a di minimis exception for contributions of $250 or less made to candidates for whom the contributor can vote.
- ***The Third-Party Solicitor Ban.*** Currently, many investment advisers rely on third-party solicitors to market the investment adviser's services pursuant to the SEC's Rule 206(4)-3. The proposed rule would end this popular arrangement and require investment advisers to offer their services directly by making it unlawful for any investment adviser covered by the proposed rule or any of its covered associates, to provide or agree to provide, directly or indirectly, "payment" to any person to solicit a government entity for investment advisory business, other than certain "related parties" or officers, partners, managing members or employees of the adviser. The intent is to ban the use of persons commonly called "finders," "solicitors," "placement agents," or "pension consultants." The term "solicit" would be broadly defined to mean: (i) with respect to investment advisory services, to communicate, directly or indirectly, for the purpose of obtaining or retaining a client for, or referring a client to, an investment adviser; and (ii) with respect to a contribution or payment, to communicate, directly or indirectly, for the purpose of obtaining or arranging a contribution or payment. The term "payment" includes any gift, subscription, loan, advance or deposit of money or anything of value.
- ***The Anti-Arranging Ban.*** It would be unlawful for an adviser itself or through any of its covered associates to solicit or to coordinate contributions (i.e., through any third person or a PAC) for an official of a government entity to which the investment adviser is seeking to provide investment advisory services, or payments to a political party of a state or locality where the investment adviser is providing or seeking to provide investment advisory services to a government entity.

The SEC is also proposing amendments to rule 204-2 under the Advisers Act to require an investment adviser that is registered or required to be registered with the SEC and (i) has or seeks government clients or (ii) provides investment advisory services to a covered investment pool in which a government entity investor invests or is solicited to invest, to make and keep records of and regularly disclose to the SEC campaign contributions made by the firm, covered employees, or PACs.

In the release accompanying the proposed rule, the SEC is requesting comment on a wide number of issues. Comments on the proposals are due by October 6, 2009.

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